

Private Letter Ruling: Newly-formed subsidiary will be a sales finance company which cannot be combined with non-financial organizations.

December 22, 1999

Dear:

This is in response to your letter dated November 15, 1999, in which you request a Private Letter Ruling on behalf of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx (hereafter "xxx") and xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx (hereafter "xxx"). The Private Letter Ruling will bind the Department only with respect to xxx and xxx for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither xxx nor a related taxpayer is currently under audit or involved in litigation concerning the issues the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

xxx is a publicly traded corporation listed on the NYSE and headquartered in xxxxx, Illinois. xxx, together with its subsidiaries, manufactures and distributes a wide range of consumable business supplies and information management products, including paper and electronic business forms, office supplies, labels, and commercial and promotional business materials. xxx and its subsidiaries' target market consists of manufacturers, distributors, retailers, service providers, wholesalers, and end-users predominantly located in the United States. xxx and its subsidiaries currently file a consolidated Federal income tax return and a unitary Illinois corporate income tax return.

The business restructuring that is under consideration relates to how xxx handles its accounts receivable function. In order to achieve greater centralization of the credit and collection function and to achieve administrative efficiencies for xxx and its subsidiaries, xxx intends to create a new Illinois limited liability company, xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx xxx. In addition to performing credit and collection functions, xxx would purchase without recourse the accounts receivable of xxx and its subsidiaries generated from the sale of products to its customers. It is intended that the factoring of xxx and selected subsidiaries' receivables will commence on January 1, 2000, with the ultimate goal of extending the factoring of receivables through xxx to all of xxx' subsidiaries over the next 12-18 months.

We respectfully request a ruling on the Illinois income tax issues which relate to the proper taxation of xxx, in particular its status as a financial organization under Section 1501(a)(8) of the Illinois Income Tax Act (hereafter "IITA") and the apportionment methodology that would result under Section 304(c) of the IITA. Presented below are the specific detailed facts which we believe would be relevant to those issues.

FACTS

- 1) xxx and its subsidiaries market their products predominantly in the United States to a variety of customers - manufacturers, distributors, retailers, service providers, national and regional wholesalers and end-users. The overwhelming majority of xxx and its subsidiaries' customers

are business organizations - mostly corporations, but also some partnerships. Only a very negligible portion of xxx and its subsidiaries' customers are individuals or proprietorships. xxx files its Illinois income tax returns as a member of a unitary business group. xxx's apportionment in Illinois has been based on its respective property, payroll, and sales factors. xxx and its subsidiaries' apportionment in Illinois will be based primarily on its sales factor for its fiscal year ending July 31, 2000 (Under Section 304(h) of the IITA, the single sales factor will be fully phased in for years ending on or after December 31, 2000). The apportionment used by xxx and its subsidiaries in other states in which returns are filed continues in most cases to be based on the respective entities' property, payroll and sales factors.

- 2) xxx and its subsidiaries make no cash sales. All sales are open account transactions, paid by check, bank wire transfers, or credit cards. This results in a substantial amount of accounts receivable for xxx and its subsidiaries. Occasionally, prepayments are required before products are shipped. In some instances, customers may be required to provide letters of credit.
- 3) xxx and its subsidiaries offer a variety of payment terms to their customers. The terms for the majority of its customers do not include any purchase price reductions for early payment. A small percentage of customers are granted purchase price reductions ranging between 1% - 2% if payment is made within 10 to 20 days. Customers who purchase certain office products receive a purchase price reduction if they make payment within 30 days of the invoice date, and a very high percentage of these customers time their payments to obtain this reduction. In addition, some customers are granted special promotional discounts and special promotional extended terms.
- 4) Approximately 95 percent of the customers pay by check, with the remaining 5 percent paying via electronic funds transfer. The electronic payments are remitted from customers throughout the United States to a bank account maintained by a national banking corporation. The payments by check from the customers are made to one of six lockboxes. The lockboxes are operated by a national banking corporation under an agreement with xxx. Two of the six lockboxes are located in Illinois. The location of each lockbox and the determination of which lockbox is assigned to each customer is based on minimizing the length of time that would be required for customer payments to reach the banking system. Currently, the services performed by the national banking corporation at various lockboxes include opening remittances, depositing the cash, and providing a tape to facilitate cash application and reconciliation by xxx's credit and collection department. After the sale of accounts receivable is instituted, these lockboxes will be maintained with customers instructed to pay xxx. The national banking corporation will continue to perform the same services that it currently performs, but will do so on behalf of xxx to the extent it has purchased the receivables of xxx and its subsidiaries.
- 5) xxx' purchase of accounts receivable will be at fair market value, which is below their face amount. The difference between fair market value and the face amount will consist of dilution and discount. Dilution represents amounts that xxx and its subsidiaries would not collect on a receivable in the ordinary course of business. Dilution includes items such as high volume discounts or rebates, fees paid to credit card

companies and various purchase price reductions for early payment which xxx and its subsidiaries provide to customers. The discount reflects prevailing market interest rates at the time receivables are purchased, the expected number of days to collect the receivables, the credit worthiness of the customers whose receivables are purchased and the costs associated with collection and cash application. Appropriate dilution and discount percentages to be applied to the accounts receivable purchased by xxx will be subject to periodic re-evaluation and revision.

- 6) There are no present plans in connection with the proposed sale of accounts receivable to xxx to alter the lockbox locations that are described in Paragraph 4, though lockbox locations of xxx as well as the number of lockboxes could change from time to time, because of changes in customer payment and banking system patterns.
- 7) xxx would be headquartered in xxxxx, Illinois. Illinois would be the only state in which xxx would have a place of business and the only state in which xxx would have employees. The employees' duties include credit and collection services and cash application. It is anticipated that xxx would have approximately 50 employees. xxx will not own any real property. Apart from income which it will earn as a result of the recovery of portions of the discount on the accounts receivable which it has factored, xxx would also have a relatively small amount of interest income on short term investments of cash collections pending purchase of new accounts receivable. Based on our interpretation of the statutory provisions in the other states in which the lockboxes are located, xxx would not be required to file income tax returns in those states, nor do we believe that xxx would have an income tax return filing obligation in any other state.
- 8) xxx would elect to be treated as a corporation for federal income tax purposes, and file a corporate income tax return, Form IL-1120, for Illinois income tax purposes.

CONCLUSIONS [OF THE TAXPAYER]

For reasons states in our Analysis below, we believe the IITA requires xxx to apportion its income to Illinois based on the percentage of its total interest payments which is represented by payments received at the Illinois lockboxes or by wire transfer at any bank account that is maintained in Illinois from corporation and partnership customers of xxx and its subsidiaries that are commercially domiciled in Illinois and from individual customers who are residents of Illinois.

In view of the scarcity of regulations and the lack of authoritative case law on the subject matter of this request, we respectfully request a ruling pursuant to 2 Ill. Adm. Code Section 1200.110 confirming our conclusions based on the analysis presented below.

ANALYSIS [OF THE TAXPAYER]

xxx' Status as a Sales Finance Company

Section 1501(a)(8)(C) of the IITA, as amended by Public Act 91-535 (August 13, 1999) defines "sales finance company" as:

- (i) A person primarily engaged in one or more of the following businesses: the business of purchasing customer receivables, the business of making loans upon the security of customer receivables, the business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower, or the business of finance leasing...

xxx' primary business will be the purchase of customer receivables from xxx and its subsidiaries. As such, xxx falls within the definition of a "sales finance company" as outlined in Section 1501(a)(8)(C) of the IITA.

The discussion above focuses on the provisions of Public Act 91-535. While this statutory language is effective January 1, 2000, the legislation also indicates it is declaratory of existing law. Under the terms of Section 1501(a)(8)(C) of the IITA as currently written, xxx would also qualify as a sales finance company.

xxx' Interest Income

Under Section 1501(a)(8)(C) of the IITA, a sales finance company is a type of financial organization. As a financial organization, xxx would apportion its income to Illinois based on Section 304(c) of the IITA.

The particular apportionment provision of Section 304(c) of the IITA, which appears to be relevant to the income of xxx, is clause (1)(C) dealing with "interest from Illinois customers." xxx would earn income equal to the discount described in fact 5, when customers make payments against their accounts receivable. From the perspective of the customers of xxx and its subsidiaries, this discount would be a measure of the value of the financing that is implicit in the deferral of the sales price for the products sold by xxx and its subsidiaries. Since this discount would be based on the prevailing market rate of interest and the creditworthiness of xxx and its subsidiaries' customers, we believe that the recovery of this discount would be "interest" within the meaning of Section 304(c)(1)(C) of the IITA.

xxx' Illinois Customers

As previously stated, xxx and its subsidiaries have a variety of customers including manufacturers, distributors, retailers, service providers, national and regional wholesalers and end-users located throughout the United States.

Section 304(c)(1)(C) of the IITA requires financial organizations, such as xxx, to determine business income from sources within Illinois by including only interest from Illinois customers which is received in Illinois. There is no express statutory definition or regulatory interpretation of the term "customer" or "Illinois customer" for purposes of Section 304(c)(1)(C) of the IITA.

In analyzing the Department's previously published pronouncements on the issue of "customer" and "Illinois customer" for purposes of Section 304(c)(1)(C) of the IITA, we are lead to the following two conclusions in determining the taxation of xxx. First, xxx would look to xxx and its

subsidiaries' customers in making the determination of who are its customers. Second, xxx will treat customers of xxx and its subsidiaries who are individual Illinois residents or persons other than individuals whose commercial domicile is in Illinois as Illinois customers.

Though none of the Department's pronouncements on the Illinois customer issue discussed above are authoritative, they appear to us independently to be the most plausible construction of the statute.

xxx' Apportionment of Income to Illinois

Section 304(c) of the IITA includes items of income in the numerator of the Illinois apportionment factor, if they are "from sources within this State." In the context of interest from a financial organization's customers, the concept of "income from sources within" Illinois is further defined in Section 304(c)(1)(C) of the IITA to mean "interest from Illinois customers, which ... (is) ... received within this State." If this same Illinois statute were operative from the perspective of the other four states in which the lockboxes are located, xxx would be obligated to file income tax returns in those four states as well as Illinois, notwithstanding the lack of physical presence in any of these states.

As previously discussed, xxx would receive interest payments from customers of xxx and its subsidiaries either by check or electronically at the lockbox locations, two of which are in Illinois. The national banking corporation at which the lockboxes are located would open the remittances, deposit the funds into the banking system and relay the paperwork to xxx' headquarters in Illinois for cash application.

There is no express statutory definition or regulatory interpretation of what constitutes "receipt" in Illinois. The Department has, however, issued numerous private letter rulings requiring interest payments made to Illinois locations by Illinois customers to be treated as received in Illinois for purposes of apportionment under Section 304(c)(1)(C) of the IITA.

xxx would have two lockboxes located in Illinois to which customers of xxx and its subsidiaries would make payments of interest. On behalf of xxx, the national banking corporation would open these remittances, deposit the funds into the banking system and forward the paperwork to xxx, located in Illinois, for cash application. As to payments to the Illinois lockboxes, those that are from Illinois customers (as discussed above), would be included in the numerator of xxx' Illinois apportionment formula, with the result that xxx would incur a liability for Illinois income and replacement tax.

SUMMARY [OF TAXPAYER]

We anticipate that xxx' Illinois income tax liability would be determined on the following basis. xxx would be a financial organization under Section 1501(a)(8) of the IITA. The recovery of the discount (as described above) by xxx would properly be characterized as interest. xxx would receive payments of this interest by check or electronically at the six lockbox locations, two of which are in Illinois. The interest payments received at xxx'

Illinois lockboxes from customers of xxx and its subsidiaries who are individual Illinois residents or persons other than individuals who are commercially domiciled in Illinois would constitute business income from sources in Illinois under Section 304(c)(1)(C) of the IITA.

OPERATIVE DATE OF THE REQUESTED RULING

xxx and xxx request that this ruling be applicable to their Illinois income tax liabilities for the fiscal year ending July 31, 2000, and all later tax years. There is no pending Illinois income tax audit of xxx and its subsidiaries or xxx as a group or either of them individually on the issues discussed in this ruling request.

[End of text of ruling request.]

Response of the Department of Revenue

Qualification of xxx as a Financial Organization

Effective for taxable years ending on or after January 1, 2000, Public Act 91-535 amends Section 1501(a)(8) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*) to define the term "financial organization" in pertinent part as follows:

(A) The term "financial organization" means any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company. For the purpose of this Section a "person" will include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956 (12 U.S.C. 1841, *et seq.*) except where interests in any person must be disposed of within certain required time limits under the Bank Holding Company Act of 1956.

* * *

(C) For purposes of subparagraph (A) of this paragraph, the term "sales finance company" has the meaning provided in the following item (i) or (ii):

- (i) A person primarily engaged in one or more of the following businesses: the business of purchasing customer receivables, the business of making loans upon the security of customer receivables, the business of making loans for the express purpose of funding purchases of tangible personal property or services by the borrower, or the business of finance leasing. For purposes of this item (i), "customer receivable" means:
 - (a) a retail installment contract or retail charge agreement within the meaning of the Sales Finance Agency Act, the Retail Installment Sales Act, or the Motor Vehicle Retail Installment Sales Act;

(b) an installment, charge, credit, or similar contract or agreement arising from the sale of tangible personal property or services in a transaction involving a deferred payment price payable in one or more installments subsequent to the sale; or

(c) the outstanding balance of a contract or agreement described in provisions (a) or (b) of this item (i).

A customer receivable need not provide for payment of interest on deferred payments. A sales finance company may purchase a customer receivable from, or make a loan secured by a customer receivable to, the seller in the original transaction or to a person who purchased the customer receivable directly or indirectly from that seller.

You have represented that virtually all of the business activities of xxx will be related to the purchase of customer accounts receivable from xxx and its subsidiaries. Under section 1501(a)(8)(C) of the IITA, xxx will therefore be a sales finance company, which is a financial organization for purposes of the IITA.

Apportionment of Business Income of xxx

Section 304(c)(1) of the IITA provides the basic apportionment rule for financial organizations, as follows:

Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State, and the denominator of which is its business income from all sources. For the purposes of this subsection, the business income of a financial organization from sources within this State is the sum of the amounts referred to in subparagraphs (A) through (E) following, but excluding the adjusted income of an international banking facility as determined in paragraph (2):

(A) Fees, commissions or other compensation for financial services rendered within this State;

(B) Gross profits from trading in stocks, bonds or other securities managed within this State;

(C) Dividends, and interest from Illinois customers, which are received in this State;

(D) Interest charged to customers at places of business maintained within this State for carrying debit balances of margin accounts, without deduction of any costs incurred in carrying such accounts; and

(E) Any other gross income resulting from the operation as a financial organization within this State. In computing the amounts referred to in paragraphs (A) through (E) of this subsection, any amount received by a member of an affiliated group (determined under Section 1504(a) of the Internal Revenue Code but without reference to whether any such corporation is an "includible corporation" under section 1504(b) of the Internal Revenue

Code) from another member of such group shall be included only to the extent such amount exceeds expenses of the recipient directly related thereto

As this statutory provision is structured, a financial organization apportions its business income by first identifying each item of business income which is described in paragraphs (A) through (D). Those items are sourced to Illinois according to the applicable rule in paragraph (A), (B), (C) or (D), and all other items of business income are sourced to Illinois under the rule in paragraph (E). The total of items sourced to Illinois is then divided by the total of all business income of the taxpayer from all sources, and the result is multiplied by the taxpayer's business income to determine the amount apportioned to Illinois.

You have requested a ruling that the amounts received by xxx from customers of xxx and its subsidiaries, to the extent those amounts exceed the amounts paid by xxx for the respective accounts receivable purchased from xxx and its subsidiaries, will be sourced under section 304(c)(1)(C) as interest income.

For federal income tax purposes, the United States Supreme Court has defined "interest" to mean "compensation for the use or forbearance of money." *Deputy v. du Pont*, 308 U.S. 488, 498 (1940). Pursuant to section 102 of the IITA, this definition of the term "interest" for purposes of the Internal Revenue Code also applies to the term "interest" as used in the IITA. As you have described the transactions by which xxx will acquire the accounts receivable from xxx and its subsidiaries, xxx will acquire all rights to payments on the receivables and will assume all responsibility for collection of the receivables, for a cash price determined by the market rate of interest at the time of the purchase, the expected time of payment on the receivables, and the creditworthiness of obligors on the receivables. Accordingly, the amounts received by xxx from xxx and its subsidiaries' customers in excess of the amounts it has paid for the respective accounts receivable will be compensation received entirely in exchange for the use of xxx' money and will reflect the factors normally taken into account in determining the amount of interest payable on an advance of funds. Such amounts will therefore be interest for purposes of the IITA, and their allocation will be governed by section 304(c)(1)(C) of the IITA.

Under section 304(c)(1)(C) of the IITA, interest income is sourced to Illinois only if it is from an Illinois customer and received in Illinois. The term "customer" is not defined in the IITA or in any relevant authority, and the definition is the proper subject for rulemaking. However, pending the promulgation of a regulatory definition, under the facts described in your request, the obligors on the accounts receivable will be customers of xxx. The obligors are all customers of xxx and its subsidiaries, which will be making credit sales in the expectation of selling the accounts receivable to xxx. Because xxx is affiliated with xxx and its subsidiaries and will be buying the accounts receivable (rather than making a loan to xxx and its subsidiaries secured by the accounts receivable) in transactions fully anticipated at the time the accounts receivable are created, the obligors on the accounts receivable will become customers of xxx at the time the accounts receivable are sold.

The term "Illinois customer" also is not defined in the IITA or in any relevant authority, and is also the proper subject for rulemaking. Pending the promulgation of regulations on this issue, the following principles should be applied. First, the term "Illinois customer" will include any individual customer

who is a resident of Illinois and any person (other than an individual) who is commercially domiciled in Illinois. Second, if the taxpayer has no actual knowledge of the residence or commercial domicile of a customer, the customer will be presumed (subject to rebuttal) to be an Illinois customer if the billing address of the customer is in Illinois.

The term "received in this State" in section 304(c)(1)(C) of the IITA is undefined, and is the proper subject for rulemaking. Pending promulgation of regulations on this issue, interest from xxx' Illinois customers will be "received in this State" if the payment is sent by the customer to a lockbox located in Illinois or the electronic funds transfer from the customer is directed to a bank located in Illinois.

In summary, the amounts xxx receives from obligors on accounts receivable purchased from xxx and its subsidiaries in excess of the amounts paid by xxx for the accounts receivable will be interest income which will be sourced to Illinois if:

- (a) the customer is:
 - (i) an individual Illinois resident; or
 - (ii) a person (other than an individual) whose commercial domicile is in Illinois; or
 - (iii) (subject to rebuttal) any person whose billing address is in Illinois if xxx has no knowledge of the person's residence or commercial domicile; and
- (b) the customer's payment is
 - (i) sent by the customer to a lockbox in Illinois; or
 - (ii) transmitted by the customer electronically to a bank located in Illinois.

Note that payments made by a credit card company (or any other third party) on behalf of a customer are payments from the customer, and should be sourced according to the same rules as payments made directly by the customer.

Duty to File Returns

Section 502(a) of the IITA provides:

A return with respect to the taxes imposed by this Act shall be made by every person for any taxable year:

- (1) For which such person is liable for a tax imposed by this Act, or
- (2) In the case of a resident or in the case of a corporation which is qualified to do business in this State, for which such person is required to make a federal income tax return, regardless of whether such person is liable for a tax imposed by this Act...

In your request you suggested that xxx and its subsidiaries have customers within Illinois. If xxx purchases accounts receivable from those customers, it will have business income sourced to Illinois under section 304(c) of the IITA and will be required to file a return under section 502(a)(1) of the IITA. If xxx is not required to allocate any of its income to Illinois, it will be required to file a

return under section 502(a)(2) for any taxable year for which it is required to make a federal income tax return.

As requested, the ruling applies to the taxable year ending July 31, 2000 and all future years during which the pertinent statutory law, case law, rules and material facts discussed above remain unchanged. The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts in this ruling.

Sincerely,

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Staff Attorney (Income Tax)